CHAPTER 1

INDIA'S TRANSITION FROM A CLOSED TO AN OPEN ECONOMY

A moment comes, which comes but rarely in history, when we step out from the old to the new, when an age ends, and when the soul of a nation, long suppressed, finds utterance.

1.1 These are the words of Pandit Jawaharlal Nehru, the first Prime Minister of India, in his speech marking the Independence of India on 14 August 1947. These words still hold true today as India moves onto the global scene and is making its presence felt as an emerging economic power.

History Since Independence

1.2 When India achieved its independence in 1947, it was 'the beginning - not the end - of a period of nation-building'.[1] India was determined to definitively break away from the imperialist influences of its former coloniser, the United Kingdom.

1.3 Prime Minister Nehru, 'armed with socialist faith in an interventionist state and an aristocratic disdain for consumerism, tried to transform India into a giant of heavy industry'.[2] India embarked on a program, combining a non-aligned movement and a socialist, centrally planned economy. This program was seen as a compromise between the extremes of capitalism and communism, combining the better elements of the West's democratic framework with the economic planning of China and the USSR. The resulting doctrine was broadly regarded as 'economic socialism'.[3]

Non-Aligned Movement (NAM)

1.4 During the Cold War, the globe was separated into two main trading blocs or superpowers. The non-aligned movement (NAM) was supported by nations not willing to commit wholly to one power or the other. India sought to identify a 'third way' in which to pursue relations with the rest of the world.[4] An Asian-African Conference (representatives from 29 Asian and African countries) at Bandung, Indonesia, in April 1955 eventually led to the First NAM Summit in Belgrade in 1961. The majority of countries involved in the NAM shared a desire to escape colonial domination.

1.5 India was a co-founder of the NAM and has played an influential role since then. Involvement with the NAM was a recognition that India needed good relations with as many nations as possible. Relationships solely with either East or West did not serve India's national interest. With the establishment of the NAM, India did not have to face the ideological battles with the West, as presented by the threat of Americanisation of culture,

1 DFAT Submission, p. S 721.
2 Thakur, R. 'India in the World: Neither Rich, Powerful nor Principled' in *Foreign Affairs* v.76 (4), July 1997, p. 15.
3 DFAT Submission, op. cit.
4 ibid.

nor did it have to rely solely on the economic stability of the USSR, which was becoming increasingly isolated from the West during the Cold War period.

1.6 Nehru's strategy to keep India non-aligned helped accelerate economic development, as India received substantial aid from both sides during the Cold War; the USSR and Eastern Europe contributed almost as much in capital goods and technical assistance as did the United States, Great Britain and West Germany.

Centrally Planned Economy

1.7 Under economic socialism, India (like China and the USSR) identified industrialisation as the key to economic growth. The implementation of socialist-styled five year plans and the centralisation of industry began. India's first Five Year Plan began in 1951; the eighth ran from 1992-1997.[5] The early five year plans followed policies of promoting import substitution, extensive state ownership of production and complex controls and regulations governing the private sector.[6] The Department of Foreign Affairs and Trade (DFAT) commented that:

> The size of the Indian economy, and the philosophical underpinnings of the industrial policy that there was a significant role for State intervention in ensuring a fair distribution of wealth, meant that the process was government-driven and controlled.[7]

1.8 Despite the regulatory constraints on local business, a negligible level of foreign investment and lack of international competition, India managed to sustain a growth rate of 4 percent per annum from 1960 to 1990. This may have been due largely to industrialisation policies and the 'green revolution'.[8] The fundamental premise was that:

> ... growth should be accompanied by social justice and this should be achieved in a way that made India self-sufficient... . [Eventually] imports were severely controlled and were subject in many cases to quantitative restrictions, and in all cases to very high tariffs, which, at their peak, had reached a maximum level of 350%.[9]

1.9 Between 1951 and 1993, India’s share of world trade plunged from 2.4 to 0.5 percent owing to Nehru's reliance on central planning as an economic policy.[10] This highly regulated, over-bureaucratised system severely inhibited competition, innovation, efficiency and economic growth. Trade policies were designed to protect local industries from external competition through high subsidies and tariffs.

1.10 As well as decreasing levels of trade participation with countries other than the USSR, India had become increasingly reliant on the USSR for technological and capital inputs. Moreover, according to DFAT:

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5 ANZ Banking Group Submission, p. S 798.
6 ibid.
7 DFAT Submission, p. S 721.
8 ibid.
9 IOC Submission, p. S 224.
10 *India's Economy at the Midnight Hour: Australia's India Strategy*, report of the East Asia Analytical Unit, Department of Foreign Affairs and Trade, Commonwealth of Australia, 1994, p. 10.

> ... investment in social infrastructure (particularly education) suffered partly as a result of India's need, as ostensibly a non-aligned state with hostile neighbours, to spend a considerable proportion of its revenues on defence equipment.[11]

Crisis for the Indian Economy

1.11 Heavier reliance by India on the economic health of the USSR meant that its demise was disastrous for India. India had already begun the slow process of implementing structural reform before the dismantling of the East European socialist economies.[12] The reform process had resulted from the recognition that policies since Independence had become outmoded and the internal economy needed intensive restructuring and a massive injection of capital. The bankruptcy of the USSR, combined with other international economic and political crises such as the Gulf Oil Shock and the increasing reliance of India on foreign borrowings resulted in a major short term balance of payments crisis in 1990-1991.[13]

Balance of Payments Crisis

1.12 India was forced to confront the severity of its economic problems when, at one stage in 1991, it was left with enough currency reserves to cover around two weeks of imports (around $1 billion). Inflation soared to 17 percent per annum. Industrial production was falling and overall economic growth had declined to 0.9 percent.[14]

1.13 The 1991 balance of payments crisis led to India's 'plunge into structural reforms'.[15] Structural adjustment programs and loans were arranged through the International Monetary Fund (IMF) and the World Bank. The Indian Government was forced to review its trade policies to allow more foreign investment and reduce trade restrictions so that India's economy could be restored to its former level. Import tariffs underwent significant reductions and import/export licensing system procedures were simplified. The opening up of capital markets to include more foreign participation has allowed Australia's entrance into otherwise untapped markets.

Managing Change from a Closed to an Open Economy

1.14 The Indian economy has responded vigorously to a program of stabilisation and reform measures started in 1992.[16] The Indian Government took drastic action including

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11 DFAT Submission, pp. S 721-22.

12 Previous bouts of reform did not change the essential orientation of the economy. From 1985, Prime Minister Rajiv Gandhi reduced trade entry barriers in some sectors, recognised that most public sector enterprises were unprofitable and acknowledged that the 'license raj' system of controls was stifling economic development.

13 DFAT Submission, p. S 734.

14 Exhibit No. 74.

15 Mayer Submission, p. S 369.

16 ASARC Submission, p. S 119.

devaluation, the imposition of higher interest rates, fiscal and monetary restraint and import compression.[17] In succeeding budgets long term measures were introduced which removed the protection for Indian industry and commerce from international competition. The reforms that were introduced are addressed in Chapter 3 of the report.

1.15 An indication of the success of these reforms is given by the change in India's current account deficit. In 1991 it had risen to 3.3 percent of Gross Domestic Product (GDP); by 1993 it had fallen to 1.8 percent, and by 1995 to 0.6 percent. The Committee heard from Professor Mayer that it was also important to realise that economic reforms occur gradually; they are 'not always as speedy as outsiders would wish and that is not unexpected'.[18] Professor Mayer stated that the trade and tariff frameworks that were set up to protect the Indian economy have begun to be wound back, but that the process is occurring 'layer by layer, strand by strand; it is not a big bang sort of thing'.[19] The Committee understands that the number of tariff bands is high, some 22 ranging from 0 to 260 percent.

1.16 From 1991 until it was voted out of power in May 1996, Prime Minister Narasimha Rao's Congress Government developed and implemented a strategy which aimed to transform India's economy from an inward-looking and protectionist one, to one fully integrated in the world trading system.[20] The process continued under subsequent Prime Ministers Gowda and Gujral and there were concerns that the recent election of the Bharatiya Janata Party (BJP) to power in India would threaten the reform process. This does not appear to be the case. The present Government's approach to economic liberalisation is discussed in Chapter 3.

Increasing Middle Class

1.17 The growth in India's economy has fostered the emergence of a sizeable middle class. The Australia South Asia Research Centre (ASARC), Research School of Pacific and Asian Studies at the Australian National University (ANU) points out that much of the market potential in India lies in its consumer market, which is seen to have immense potential. Although the size and growth are debated, it is accepted that India's middle class will determine the consumer potential for India. At this stage of Indian development, the middle class is predominantly rural and it is argued that this market potential has scarcely been tapped.[21] ASARC suggests that although consumption of some trade items has increased rapidly, a large gap exists between actual and potential consumption:

> Statistics reveal a high level of aspiration, a fast changing pattern of consumption, and a higher level of penetration at these lower income levels than would be expected. India is currently in the throes of a boom for consumer products. It is leading to the emergence of new values in consumption and in new aspirations.[22]

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17 SARU Submission, p. S 481.
18 Mayer Transcript, p. 419.
19 ibid.
20 DFAT Submission, p. S 734.
21 ASARC Submission, p. S 123.
22 ibid.

1.18 Although it is widely recognised that the market is substantial and growing, DFAT suggests it is probably only the upper middle class (of approximately 30 million people) that could be regarded as affluent enough to 'fuel growth and demand for imports'.[23] The nature and extent of the Indian middle class as a potential market are discussed in Chapter 3.

The Role of States

1.19 There are different political parties in power across the 26 states in India, with a wide range of differing economic priorities.[24] At the state level, economic liberalisation has meant the freeing up of the states from central control over heavy and medium industry. The South Asia Research Unit (SARU) suggests that prior to major economic reforms being implemented, the Central Government 'had the power to approve of domestic and foreign economic investment decisions as to the location of heavy and medium industry'. SARU states that with this power, the Central Government could bolster the economies of some of the more backward states, and in practice, used 'pork barrelling' to buy political support at the state level.[25]

1.20 Under the new economic policies of liberalisation, states now have more control and responsibility for economic planning and have been seeking foreign investment independently. While liberalisation has removed a significant number of trade barriers, it has also meant that states are becoming increasingly competitive for development and investment opportunities. SARU points to a case study of West Bengal to demonstrate that 'the process of economic liberalisation needs to be understood in the context of centre/state relations and politics at the state level'.[26] It has also been suggested that the rise of regional political parties has reinforced the tendency for State Governments to lead liberalisation reforms.[27] The Committee understands that where economic liberalisation has produced the most inequality and hardship, (usually in the economically backward states), incidences of sectoral violence, division and conflict have increased.[28]

1.21 Despite numerous risks resulting from increased competition between states, it has been put to the Committee that such competition will ensure that the process of reform is sustained. States are aware that their continued development will depend upon their success in attracting investment. It is this state-level force for reform that should ensure the continuation of policies of economic liberalisation.[29] Professor Mayer suggests that Indian states' mounting budget deficits and increasing interest payments have led to a greater reliance on borrowing funds, in turn adding to the burden of interest repayments.

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23 DFAT Submission, p. S 724.

24 For instance the BJP is the ruling party in Gujarat, Rajasthan, Uttar Pradesh & New Delhi; Shiv Sena/BJP is in power in Maharashtra; the Telugu Desam Party is in power in Andhra Pradesh; the Congress Party is in power in Goa, Madhya Pradesh, Orissa, Naga & Mizoram, and the Communist Party of India is in power in West Bengal.

25 SARU Submission, p. S 485.

26 ibid. p. S 491.

27 *Far Eastern Economic Review*, 'Investment - Rajasthan Inc.' by Henry Sender, 9 April 1998, p. 58.

28 SARU Transcript, pp. 489-490. For examples of discussion of states competing for investment, see SARU Submission, pp. S 486-491; Austrade Transcript, pp. 264-265. See also SARU Transcript, pp. 483-484.

29 See Mayer Submission, pp. S 370-372. See also SARU Transcript, p. 484.

1.22 It was suggested by Kinhill that the liberalisation process has affected different states very differently.[30] It appears that some liberalisation policies have not filtered so far into existing systems as to make businesses fully effective.[31] The Committee understands that many Indian states remain unknown quantities in terms of their business orientations and investment profiles, and the potential for foreign investment opportunities. *The Far Eastern Economic Review* notes that since 1991, the states to attract the most investment are Maharashtra, Gujarat, Tamil Nadu, Karnataka and Andhra Pradesh.[32] A recent Goldman Sachs study on structural reform in Indian notes that:

> The pace and extent of reform are directly proportional to the responsiveness of the bureaucracy and the degree to which the state's regulatory and political environment are seen as investor-friendly.[33]

Globalisation

1.23 The liberalisation of otherwise restricted areas of India's global economy is largely motivated by the country's new policy of 'globalisation'[34] which aims to upgrade technology and infrastructure to enable India to increase its competitiveness to that of world standards. Sandy Gordon's article, which examines global and economic reform in India, suggests that globalisation has shaped a new, more pragmatic and expansive Indian foreign policy and highlights a new determination on India's part to successfully 'play... in the global game'.[35]

1.24 It should be realised however, that India has not 'cut itself adrift from its past, magically, ... and has fully embraced a Western capitalistic view of the world'.[36] The Indian Ocean Centre (IOC) stated that the arms trade between India and Russia is still 'alive and well'.[37] Further, the Committee accepts that:

> ... economic diplomacy is still being integrated into India's foreign policy and old relationships are hard to re-orientate. This can be seen

30 Kinhill Transcript, pp. 410-412.

31 See also West Transcript, p. 53, which mentions varying degrees of State Government bureaucracies' commitment to economic liberalisation and reforms.

32 *Far Eastern Economic Review*, 9 April 1998, op. cit.
Maharashtra is the most industrialised state in the Union and accounts for 23 percent of the country's total industrial output. **Gujarat** has emerged as one of the leading industrialised states in India with a highly diversified industrial base. **Tamil Nadu** is one of the most industrialised states of the Indian Union and is well connected with the rest of the country by rail, road and air. **Karnataka** is one of the most highly industrialised states and is very investor friendly. **Andhra Pradesh** is the granary of southern India, has a diversified industrial sector and the Telugu Desam Party is committed to carrying forward the economic reforms and extending all possible assistance to promote private investment.

33 ibid.

34 The term 'globalisation' is defined as the trend for trade, finance and industry to assume a global (as distinct from a regional or national) dimension.

35 Gordon, S. 'Globalisation and Economic Reform in India', in *Australian Journal of International Affairs* v. 51, no. 1, 1997, p. 75. Sandy Gordon was formerly with the Research School of Pacific and Asian Studies, Australian National University.

36 IOC Transcript, p. 491.

37 ibid. p. 492.

> in India's continuing commitment to the NAM, and in the 1993 signing of a new Treaty of Peace and Friendship with Russia.[38]

1.25 The breakup of the USSR and the rise of economic liberalisation within India has changed its trading pattern dramatically. Less dramatic but still significant is India's trade with Indian Ocean countries. As ASARC suggests, 'much groundwork has recently been laid for the encouragement of linkages through the creation of regional cooperative processes'.[39] Improvements in regional bilateral and multilateral trade have been partly due to India's commitment to a 'Look East' policy, embarked on by the Rao Government.

1.26 While this Chapter has outlined India's transition from a closed to an open economy, issues such as regional linkages will be discussed in Chapter 8. The Committee understands that:

> The 'new' India is rapidly shedding its old image of an autarchic, self-reliant, closed economy, largely independent of the world economy. In expanding its economic engagement internationally, India is emerging with prospects of becoming one of the world's economic superpowers early in the 21st century.[40]

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38 DFAT Submission, p. S 770.
39 ASARC Submission, p. S 101.
40 ibid. p. S 113.